*** TRANSCRIPT ***

[The state of sustainability performance measurement: A conversation with Nils Kok]

Podcast interview with Nils Kok, co-founder and Executive Director of GRESB; and Will Teichman, Director of Sustainability for Kimco Realty

Will: Hello and welcome to a Kimco Realty podcast on the Kimco blog. This is Will Teichman, Director of Sustainability for Kimco. With me today I have Nils Kok, who is Associate Professor of Finance and Real Estate at Maastricht University in the Netherlands as well as a visiting scholar at the Goldman School of Public Policy at UC Berkeley.

Nils Kok is known very widely in energy efficiency and sustainability in commercial real estate. He's also the co-founder of the Global Real Estate Sustainability Benchmark, which is an investor survey soliciting information about sustainable governance and social practices of large real estate companies globally. Nils, welcome to the Kimco podcast.

Nils: Thank you, Will.

Will: I'd like to start by asking a question. We first became aware of your work through the Global Real Estate Sustainability Benchmark. As I said, it's an investor-driven disclosure effort focused on sustainability. Could you tell us a little bit more about your role in starting GRESB and the purpose of the organization?

Nils: Absolutely. Before I do it, I think it's good to take a little step back. In 2007 we started research on energy efficiency and sustainability and financial implications in the commercial real estate market. I did that research with collaborators here at UC Berkeley and also at Maastricht University.

We found there was a relationship between environmental factors on the one end and market indicators—like rents, prices, evaluations—on the other hand. If you believe that, and investors believe that, it's important to take those factors into account when making investments or investment decisions in real estate.

When we pitched this information and presented this information to some pension funds in 2008, they immediately thought about opportunities to include this information when doing due diligence on REIT investments, when doing due diligence on investment in private funds, but also to use it for engagement purposes. That's really how GRESB was born.

At that time, in 2008, there were asset level initiatives—for example, LEED and Energy Star in the U.S., and other comparable metrics in Europe, Asia, and Australia—but there was really nothing at the portfolio level. There were some rating agencies looking at EC issues in real estate, looking at REITs specifically, but really more focusing on child labor and nuclear energy, which is important but not necessarily for real estate in the U.S.

We set up a portfolio-level sustainability benchmark to measure the efforts and the performance of REITs and their private counterparts. It was 2008 and that was really the first year we went out to the market, on behalf of these pension funds. They were APG Asset Management, which is among the

world's largest pension funds, so a large investor in the U.S. and in U.S. real estate; PGGM Investments, which is a large pension fund from the Netherlands; and USS, which is the teachers fund in the U.K.

On behalf of all these investors, we went out into the market to the REITs they invested in, to the private fund managers that they worked with, and we asked questions in a structured survey about sustainability issues. That includes energy efficiency, but also broader themes. We'll get back to that—like stakeholder engagement, so how do you deal with your tenants, with your occupants and with the community around the properties that you own and manage.

That was very successful. We got about 200 responses on that survey. It was really more of a data collection tool rather than a straight-forward survey. We used the data to score and then to benchmark REITs and private funds. It was so successful that GRESB basically grew out into a platform that is now used by 45 investors, becoming the standard when it comes to sustainability performance and benchmarking in the commercial real estate sector.

Will: Nils, you deal pretty directly with a lot of these large institutional investors. You mentioned three of them by name. Could you give us a little bit more insight into what they're doing with this information? At Kimco we're on the receiving end of a lot of these investor surveys. We fill them out, we provide the information. I think we're very curious and probably some other listeners are curious, what are they doing with the information? Is it changing their investment decisions? Could you tell us a little bit more?

Nils: What I think is very important to realize is that this is not about SRIs, as it's often called, socially responsible investments, so mission driven investors, Catholic Church, or labor funds. Those have very particular views on how they want to allocate and invest their money. A typical pension fund is mostly concerned or maybe solely concerned about optimizing risk and return, so within a given risk bandwidth optimizing returns. That's important to realize because the investors that use the information are mainstream institutional investors.

I mentioned APG, which has about 300 billion euros of assets under management, but also Townsend Group that invests one of the 10 billion in real estate on behalf of 90 institutional clients. These are mainstream institutional investors that see risks and opportunities when it comes to sustainability in real estate.

It's important to realize it's about both risk and opportunities. Risk in that a given investment manager or a REIT property company does not include or integrate issues related to energy efficiency to which management acquisition and disposition of properties that might lead to lower return or faster depreciation of the property.

When pension funds look at the data that we collect, they do not necessarily screen out. They don't say, 'We don't want to invest with the lower ranking companies.' But they merely use the information to engage with their holdings. Pension funds typically have a longer horizon, in terms of three to five years, and really investing for the next and future generations.

When they invest and when they stake both in the due diligence phase and in the engagement stage, they use the information to have conversations with their investments. At this point we don't see exclusions based on sustainability performance, but we do see an increased level of engagement.

Maybe to add some juice to that, there are investors out there, so really investors with a socially investment responsibility mission that would not invest in a company, for example, that does not fill out a survey or does not disclose. In their search they have that as a requirement. We've seen that. That's really about do you disclose or not, but not really about how you perform. That comes in later stages.

Will: You talked about risk and opportunity. I think that's very interesting. Maybe for the benefit of listeners who aren't familiar with the questions that are contained within the survey, could you give us an example of a type of a question that you ask in the survey that would give an investor an indication of whether a company is, for example, pursuing the types of energy efficiency or operational strategies that might mitigate a risk, or conversely, create a business opportunity.

Nils: The questionnaire has 42 individual questions and they focus on energy. And within energy, you could think about a question like, have you, as a landlord, done energy efficiency audits or assessments of your properties over the last three years? If yes, what are the outcomes and have you taken measures to improve the energy efficiency of your properties?

And if yes, what kinds of measures are included? Is it just about lighting? Is it about retro commissioning of HVAC systems? Have you looked at the envelope of a property? That's really assessing the energy efficiency performance of properties. And then the next step, how did you improve that?

We also look at data collection. Do you collect data on energy, but also water and waste recycling? Interestingly, that question in and of itself is a very revealing question. Within the area where you as a landlord have control, do you actually know how much you consume? Often, if you think about REIT-held real estate, landlord control is limited, so do you work with your tenants to understand how they perform? Do you talk with them about their performance and then help them?

Will: Would you say that for companies who do collect data, that says something about them beyond the fact that they're able or they have some mechanisms in place to collect information? Are there broader inferences that investors make about a company and its management based on the fact that they have taken some initial steps or put some initial systems or programs in place to start to collect and track that information?

Nils: I think this is a very good point. When you invest in real estate, whether it's directly in real estate, and most pension funds and other institutional investors like endowments and insurance companies mostly invest indirectly in real estate, so you work with a REIT management team or you work with a private fund manager. The level of disclosure, the level of transparency is there, but it's relatively limited.

Information about activities in the sustainability space is very informative to investors to better understand the management quality of the property. What we hear a lot is that sustainability can also be seen as a proxy for management quality. In some property types—for example, industrial warehouses or multifamily, but also retail, especially strip malls—it's more difficult as a landlord to do something because the level of operational control is limited.

The early steps of putting systems in place and having engagement lets them add value by investors. Interestingly, by making comparisons between, let's say, a Kimco and another retail REIT or maybe a retail front on the private side even, if it's difficult to implement sustainability initiatives, you can see the differences and those differences are a very good indication of management quality.

Will: We know that GRESB isn't your day job, so why don't you tell us a little bit more about you full-time role as a professor and researcher both in the United States and overseas.

Nils: Honestly, it obliges me to say that I do spend a lot of time on GRESB with the growth over the last couple of years. We do have a team of eight people, but still there's a lot of information that comes in, a lot questions that come in. I also think there's a lot of education to be done, both among investors and among property companies.

Besides that, or maybe what I should be doing full time, is academic work, academic research on energy efficiency in commercial real estate. One example is a paper called the "Economics of Green Building," where we looked at the financial implications of Energy Star and LEED certification for commercial offices, and that laid the foundation for more work in that space.

I'm also interested in the role of regulation. For example, mandatory disclosure in the U.S. and how that might affect the value of buildings, but also the performance of these buildings. I really think in the next stage the role of technology can be in the performance of commercial and residential real estate.

Thinking about automated building optimization, building engineer versus IT systems, providing real-time feedback to tenants, to occupants, and the role that may have in influencing behavior. That's what I spend my time on when I think about research and starting to do more and more work on the retail side as well.

Will: I noticed that some of your recent publications, and the "Economics of Green Building" is one of them, have suggested that sustainably built and managed real estate assets tend to perform better, whether that is translated into premium rents that they can achieve or higher overall asset values. Could you briefly summarize your findings on the topic and perhaps discuss a little bit more about what types of buildings and what classes of real estate that research focused on?

Nils: We compare, and then in a statistically sound manner, the performance of buildings is measured in rents, occupancy rates, and transaction prices. We look first and foremost at commercial offices. We start to look at residential real estate. What we find is that again, you mentioned it already, premiums or discounts, but there's a difference in rents on average in the U.S. of about 3%. And there's a difference in effective rents that takes occupancy rates into account of about 7%.

Between green or efficient buildings on the one end and non-green, non-efficient buildings on the other end, and importantly that controls for the fact that greener buildings might be newer, might be more centrally located, might be Class A versus Class B. So using our statistical methods, we're able to very precisely control for that.

When we look at transaction prices, we find that there's a real significant difference in prices of about 15% between green/efficient on the one end and inefficient on the other end. That has been quite consistent over the years. We did it in 2007, we did it in 2010. We're looking at a follow-up study this year.

Throughout the crisis where you would expect that green buildings would suffer more, we actually found that these value differences held up fairly consistently and fairly robustly. That really indicates that part of this is really driven by the intrinsic value that energy efficiency and broader sustainability

bring to a building. A lower energy bill ultimately should translate into a higher effective rent, so higher occupancy rates and higher net rents paid by the tenants.

Will: Nils, we both recently attended NAREIT's Leader in the Light forum, which is a gathering of sustainability professionals from large real estate investment trusts. At that forum, there was an in-depth discussion about the fact that many of the efforts to quantify the financial benefits of green buildings have focused on a specific subset of sectors. Office is one of the sectors that is mentioned quite frequently. You're very familiar with the research having done a lot of this original research. In your opinion, why has retail been excluded from the literature to date?

Nils: I think that's a very important question. If you think about the metrics that are relevant for retail, whether it's high street, whether it's enclosed shopping malls, whether it's strip malls, it is about occupancy and rent. But it's also, if you think about what's important to the retailers, the number of visitors, the turnover in stores, some other metrics that you look at in retail. How consumers perceive the retail store or the mall?

At this point, there's no common platform to measure some of these outputs and certainly there's not a widespread input of metrics to actually measure the energy efficiency or the sustainability of retail real estate. LEED and Energy Star are not as widespread for retail. There are some LEED-certified stores under a LEED program, but that's it. Energy Star is very difficult because you really need to include the tenant consumption there.

On the one end, there are no tools or metrics to measure how shopping centers or how strip malls might differ when it comes to sustainability. And on the other end, there's no real common denominator or common platform to measure the performance of these properties, and certainly there's no easy source of obtaining the data.

As an academic, that's what you're looking for—a platform where you can get rents and prices and occupancy rates and number of visitors. I believe also going forward that this is very important for the industry to collaborate upon. Collaboration is really necessary, because Kimco could do a study of its own, but it's going to be much more powerful if it's jointly done by some of the larger retail owners in the U.S.

Will: Let's assume for the moment that some of those measurements and other challenges that you have identified could be overcome. You're a social scientist, so I assume you're comfortable coming up with hypotheses. Could you hypothesize about what green retail buildings might be?

For example, you mentioned that retail is a little bit different in some of the metrics we might measure, such as the focus of retailers on foot traffic within their stores. Could you hypothesize on what some of those benefits might be for retail and whether those would be similar types of benefits to office buildings or perhaps additional benefits or perhaps a different set of benefits?

Nils: I think there are certainly benefits that are common to office, retail, and other property types, and that comes down to operational cost savings. For retailers, if you look at direct energy consumption, most of that actually comes from the stores that they operate in. They buy the computers that they sell, so it’s an indirect energy consumption. Most of the direct energy consumption in stores comes, again, from lighting, and not so much from appliances.

If you think about what drives value in a commercial office, it's mostly energy efficiency. Then there are side benefits, which in an office are better productivity through natural lighting, etc., etc. That holds to some extent for retail, but with green retail real estate or more sustainable retail real estate I really think about attracting consumers, customers who find that shop, that mall, a pleasant place to be in. That's not just related to operational performance.

If you go shopping, you don't feel that a store is energy efficient. You'd rather not want to feel it. You don't want to feel hot or you don't want to feel cold, so fine if it's energy efficient, but you really want to shop in a pleasant place.

That is, for example, related to natural lighting. There have been many experiments, for example, by one of the largest retailers in the U.S., on skylights and what that does to shoppers' behavior. We do know from a lot of marketing research that shoppers are sensitive to the outlay of a store, but also to the amount of natural light.

I'm convinced that increasingly shoppers will be attracted to places that can also show they're good citizens in the community. You can think on the one hand about recycling and what you do with the parking lots, what you do with some of the vegetation and some of the plant terra out there. But also if you think about solar, and how is the shopping center used for renewable energy generation.

With retail, you can also think about community engagement. So how is the shopping center part of the social fabric or the urban fabric in the community? Typically shopping centers are fairly large so they have impact on the community and they can be used for fundraisers. They can be used as starting points for runs, etc.

I do believe that retail is quite well positioned from a sustainability perspective to do more than just achieve operational cost savings. And I also believe that's going to play out in the metrics. And the metrics are a turnover in stores and foot traffic, and that will ultimately tell us that retailers are being satisfied and leasing more space, renewing their leases and the rent that you as a landlord want to achieve.

Will: I want to shift gears and then we'll wrap up. The last question I wanted to ask you is around building benchmarking. You mentioned this earlier in your comments. Over the last five years, a number of states and municipalities have passed whole-building energy and benchmarking disclosure laws. If I'm correct, I believe Boston actually passed a law yesterday, which is the latest city in the United States to join this group of cities.

I speak to many owners who don't understand where all of this data collection is headed. Since you're in the business of data collection and in the business of analyzing that data, I wonder if you could provide some perspective, compared to what the Australians and the Europeans have enacted. And really, where is all this data collection headed?

Nils: I think that's a really important question. Europe and Australia have seen mandatory disclosure for a couple of years now. I have to say not without struggle, certainly not in Europe, as things go in Europe. Australia has been more successful from that perspective.

The purpose of benchmarking and mandatory disclosure is really to establish a common platform, a common denominator for whole-building energy consumption. Importantly, in Australia and the U.S.,

it's based on real energy consumption. In Europe, it's very often based on an intrinsic. So how could the building perform? It's basically a mile per gallon rather than a real consumption, and we know those might differ.

First and foremost, governments want to establish this common platform. Once it's there, and what has happened in Australia and in Europe, that information might be included in leasing and sales transactions. In Australia, there are beautiful examples of pictures where you see that there's space for lease and then it also mentions the energy performance of the building. It's right there when you try to lease some space. In Europe, it's also there when you want to transact commercial space.

The third step is these forms of disclosure are linked to regulation more explicitly. Regulation as a stick and also regulation as a carrot. There are incentives that are tied in Europe if you improve your energy performance as measured by the energy label. That label goes from A to G, so if you go from D to B, so you make two label steps, you can get a certain amount from the utility or the government in incentives. That's the carrot part.

But a stick part is present in the U.K. where F- and G-labeled properties, those are the least efficient properties, can no longer be leased out as of 2018. That's where regulation is directly tied into disclosure. I don't see the U.S. going there in the next couple of years. I also don't think that's per definition necessary to make it unlawful to lease out inefficient space. I think the market can do that itself because that space should be less attractive to be in and tenants want to pay lower rates, etc., etc.

But you can see where mandatory disclosure is going. All of that is important as a simple but effective system. Energy Star has been that for most property types, if not all, and I think those wrinkles should be ironed out. Examples that some cities have set I think at some point are going to be copied at the federal level.

Now it only includes buildings that are larger than 50,000 square feet that will be lowered over time, and other property types might be included. Ultimately it will be more directly linked to regulations. I think that's where the world is going and that world includes the U.S.

Will: Very insightful. Thank you very much. Our last question in closing is, what's one factor that retail property owners should consider when it comes to sustainability?

Nils: I'm convinced that within retail, as a landlord where you have less control over your tenants, stakeholder engagement is key. We discussed this earlier in this conversation. Stakeholder engagement of course includes what you do in the community, what you do with your suppliers, what you do with your employees, but it also includes—this is very important—what you do with your tenants.

We both know it's not easy to convince a large retailer that they should work with you on retrofitting because they might be convinced that's going to negatively affect their sales. They might not be willing to share data on energy consumption, whereas you want to have that in order to benchmark the building.

Sometimes tenant engagement, a push and pull, is very important. The landlord is able to help the tenant and the tenant ultimately is needed in that conversation, that collaboration. I think more than in any other property type, in retail, tenant engagement is key to success.

Will: That's a great wrap up question. I think it sets us all off in a good direction. Certainly at Kimco we're trying to work more extensively on, and something that as an industry we can do more in terms of tenant engagement.

Nils Kok, I'd like to really thank you for taking the time to spend half an hour with us here on the Kimco Realty podcast. For those of you who are interested in finding out more or following more information from Nils, you can follow him on Twitter @NilsKok, N-I-L-S-K-O-K, or you can follow us, Kimco Realty, @KimcoRealty or @KimcoCR. Nils, thanks a lot for taking the time. We really appreciate it.

Nils: Thank you.

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